7 August 2002

MEMORANDUM FOR DEPUTY AUDITOR GENERAL, POLICY AND OPERATIONS MANAGEMENT, ARMY AUDIT AGENCY

FROM: HQ AFAA/DOV
1125 Air Force Pentagon
Washington DC 20330-1125

SUBJECT: Letter of Comments, 2002 Peer Review of Army Audit Agency (Project F2002-A12300-0663.000)

Background. In accordance with the Memorandum of Understanding dated March 2002, we completed an external peer review of the Army Audit Agency (AAA). Our formal report, under separate enclosure, concludes that the AAA's quality control system meets standards established by the President's Council on Integrity and Efficiency (PCIE) and provides the AAA with reasonable assurance that auditors follow professional standards and internal policies. This letter contains observations and suggestions regarding issues that did not warrant inclusion in the formal report.

Objective. We determined whether the AAA's internal quality control system operated effectively to provide reasonable assurance that audit teams followed internal policies and procedures as well as applicable government auditing standards. Specifically, we:

a. Evaluated and tested the AAA's quality control policies and procedures related to staff qualifications and independence and evaluated the design of quality control policies and procedures related to audit performance and internal review.

b. Determined whether the AAA internal quality assurance (QA) program was adequately designed to meet established quality assurance objectives.

c. Evaluated two recent QA program projects to determine if QA teams performed the reviews in accordance with AAA's internal policies and procedures.

d. Determined for a sample of two financial audits and seven performance audits whether auditors adequately planned, executed, and documented procedures in accordance with auditing standards and AAA's quality control policies and procedures.

Overall Conclusion. The AAA's internal quality control program generally operated effectively and provided reasonable assurance that audit teams followed internal policies and procedures and

applicable government auditing standards. The AAA designed its overall internal quality control system in accordance with applicable standards, and AAA auditors generally complied with established quality control policies and procedures. Although some areas needed improvement, the peer review team concluded that the seven performance and two financial audits reviewed complied with government auditing standards and internal policies and procedures. Specifically, AAA:

     a. Policies and procedures related to staff qualifications, education, and independence complied with government auditing standards. In addition, AAA's quality control program and procedures related to audit performance and internal review adequately ensured auditors accomplished their audit projects m accordance with government auditing standards. However, the AAA had not developed and implemented specific policies and procedures for (1) conducting the planning phase of an audit and (2) complying with the data reliability-reporting standard. *(See* Observation 1)

     b. Adequately designed its internal quality review program to meet quality assurance objectives, and assigned highly qualified and experienced auditors to conduct internal quality control reviews. Further, during the review, the internal QA program was functioning according to Agency policy, projects appeared to be well designed, and reports were well written and identified conditions that needed improvement. However, the AAA needed to apply additional resources to the internal quality review program to a) assure achievement of all program objectives, and b) adequately cover all auditing standards and AAA's implementing policies and procedures. In addition, management comments included in quality assurance reports needed to identify specific actions and include estimated completion dates. **(See** Observations 2 and 3)

     c. Quality assurance projects gathered adequate evidence to establish that Agency auditors generally complied with government audit standards and internal policies and procedures. Further, QA teams generally conducted quality assurance projects in accordance with AAA internal policies and procedures. Consequently, the AFAA review team used the resulting quality assurance reports to support its opinion on the AAA's internal quality control system operating effectiveness.

     d. Auditors planned and conducted the seven performance and two financial audits reviewed m accordance with government auditing standards and AAA internal policies and procedures. The project reports and supporting documentation provided ample evidence that auditors properly planned and executed the nine audit projects, and the working papers adequately supported the conclusions reached during the audits. However, AAA audit teams needed to improve independent referencing, working paper review documentation, and internal quality control checklist accomplishment. They also needed to complete the risk and control assessment documents financial audits require. **(See** Observations 4 and 5)

OBSERVATIONS AND SUGGESTONS

Observation 1 – Poky Issues. The **AAA** had not developed and implemented specific policies and procedures for **(1)** accomplishing the audit planning phase and (2) complying with the data reliability-reporting standard.

      a. <u>Audit Planning Guidance</u>. The **AAA's** planning-phase guidance was limited and dispersed among several regulations. Specifically, planning guidance was included in USAAA Regulation (USAAAR) 36-73, *Audit Programs,* 10 March 1995; USAAAR 36-40, *The Workload Survey,* 31 March 1998; the *AIC E-Book,* undated, and USAAAR 36-91, *Audit* by *Objectives,* 1 December 1994. Although all these regulations identified some planning phase requirements, they collectively did not identify all government auditing standards. For example:

      (1) <u>Management Controls</u>. Although USAAAR 36-91 and other **AAA** regulations made it mandatory to review controls in **every** audit, they did not specify that auditors should review controls in the planning phase. In addition, AAA regulations did not require auditors to include audit program steps to test controls. However, audit supervisors were generally aware of the need to review controls in the planning phase. Auditors reviewed controls in the planning phase and included audit program steps to test controls for all but one audit reviewed.

      (2) <u>Data Reliability</u>. **AAA** regulations did not specify auditors' planning-phase responsibilities for verifying wmputer-processed data reliability. **Further,** AAA regulations did not require audit program steps to validate the reliability of wmputer-processed data **supporting** audit conclusions. Of 4[1] audit programs, 3 (75 **percent)** did not include steps testing data reliability.

      b. <u>Reporting</u>. The **AAA** had not developed specific guidance implementing data reliability reporting requirements contained in **GAO/OP-8.1.3,** *Assessing the Reliability of Computer Processed Data,* April 1991. Of 6[2] reports, 5 (83 percent) did not meet the data reliability reporting requirements. That is, the reports' objectives, scope, and methodology sections did not identify the computer-processed data auditors tested, the test results, or the auditors' conclusions regarding data reliability. For some audits, the data reliability discussion helps managers better understand the audit results and the manner in which the auditors conducted the audit.

      Suggestion 1. The Deputy Auditor General for Policy and Operations Management should:

      a. Develop guidance for the audit planning phase that provides auditors a single reference for determining planning-phase requirements (i.e., what the auditors need to accomplish to adequately plan an audit).

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[1] The total universe was nine projects, however, only four projects used computer-processed data.

[2] The total universe was nine projects, however, only six projects had data reliability reporting requirements.

b. Develop guidance that implements the reporting standard on computer-based data reliability.

Management Comments. The Deputy Auditor General for Policy and Operations Management concurred with the observation and suggestions and stated:

a. "We began consolidating audit-planning requirements for use on all Agency audit engagements into one new regulation in June 2002. Our target date for completing the regulation is 31 October 2002.

b. "We began developing a new regulation prescribing policy to implement the reporting standard on testing of computer-based data reliability in July 2002. Our target date for completing the regulation is 31 December 2002."

Observation 2 – Quality Assurance Program. The AAA needed to apply additional resources to the internal quality control review program to assure achievement of all program objectives. This is a repeat condition from the 1999 peer review.

a. **Program Scope.** In the approximately 3-years (June 1999 – March 2002) since the last peer review, the AAA completed only three quality assurance reviews. Further, the scope of all three reviews covered a very narrow range of government auditing standards and implementing procedures (see Table 1). Consequently, quality control coverage limited the AAA's assurance that auditors followed auditing standards and implementing policies and procedures.

b. **Causes.** Several factors contributed to the quality assurance program's liited coverage.

(1) <u>Timeliness</u>. One factor impeding the program from completing more reviews and achieving wider coverage was the amount of time required to complete each review. For example, AAA started one review in October 1999 but did not finish (the application phase) until June of 2000. The AAA did not issue the report until March 2002. A second project took 10 months to complete (5 months in application and 5 months in report writing and processing). The AAA goal is to complete a quality control review in 3 to 4 months.

(2) <u>Individual</u> **Project Coverage.** Another factor impeding the overall program from achieving wider scope was the limited coverage of the individual reviews completed between 1999 and 2002. One review focused on verifying the reliability of computer-processed data. A second review focused on follow-up reporting. The final review focused on consulting projects (mostly non-audit). In the 3 years since the last peer review, the quality assurance staff did not once use the internal quality control review checklist (expanded). The expanded checklist covers all aspects of the audit process, and the AAA developed the checklist specifically for this purpose.

Audit Phase Activity	1999-2002
Planning	
Entrance conference conducted	o
Prior audit coverage reviewed	o
Management controls identified	o
Audit program developed/adequate	o
Working papers prepared and reviewed	o
Application	
Validity of computerized data verified	x
Adequacy of controls and compliance assessed	o
Findings contained required elements	o
Findings validated with management	o
Audit accomplished timely	o
W/Ps prepared, summarized, cross indexed, and reviewed	o
Report Processing	
Report contained all required elements	x
Report answered all announced objectives	o
Findings contained all required elements	o
PMB was accurately computed	o
Recommendations were logical	o
Command comments and audit response included/accurate	o
Independent referencing completed/adequate	o
Internal Quality Control Review Checklist completed	x

Table 1.   Scope of Quality Assurance Reviews (1999-2002).[3]
o = not reviewed   x = reviewed

(3) Project Staffing. **A** final contributing factor was the practice of employing the entire QA staff collectively on each single project. Assigning one staff member per project would potentially increase the number of quality assurance reviews accomplished each year.

Review Comment. The comments above applied to the entire 3-year period taken as a whole. In the 6 to 12 months just before the peer review, quality control review program productivity accelerated. The AAA issued three quality assurance reports in March 2002, and each successive project took less time to complete. The AAA had a fourth quality control review report in the draft report stage as the peer review ended. Further, the quality control review program plan for the remainder of Fiscal Year (FY) 2002 and 2003, if completed, will cover several auditing standards (e.g., planning, supervision, and independence).

Table 1 indicates only the quality assurance work accomplished involving audit-related projects. It does not include quality assurance work accomplished on non-audit projects. The AAA quality assurance staff did complete one project in 2002 that evaluated compliance with internally established standards for consulting engagements.

Suggestion 2.   The Deputy Auditor General for Policy and Operations Management should:

   a.   Establish milestones for each quality assurance project and monitor project progress against each milestone.

   b.   Include broader-scoped quality control review projects in the annual quality assurance plan.   We suggest projects using the internal quality control review checklist (expanded) to evaluate at least one audit engagement per program director in a 3-year cycle.

   c.   To the extent possible, assign one quality assurance staff member per project as a means to increase productivity.

   Management Comments.   The Deputy Auditor General for Policy and Operations Management concurred with the observation and suggestions and stated:

   a.   "We are updating our FY 02-03 quality assurance plan to include **milestones** for the respective quality assurance projects.   We will **finalize** our FY 03-05 plan by 30 September 2002. Additional Information. In February 2002, the Agency implemented a new management information system that we're using to monitor established milestones for all phases of a project.

   b.   "We will include broader-scoped quality assurance reviews in our FY 03-05 quality assurance plan.   Specifically, we plan to include more aspects of the audit process (planning, application and report processing) in each of the respective reviews.   However, we believe that we can still provide sufficient coverage of audit processes by performing reviews across multiple program directors.   This will allow us to identify whether there are systemic issues and risk areas Agency-wide."

   c.   "To the extent possible, and based on complexity, and the depth and breadth of the quality assurance projects, we will assign one quality assurance **staff** member per project to increase productivity."

Observation 3 – Management Comments. The operating Deputy Auditors General comments in the most **recent** quality assurance reports did not indicate specific planned corrective actions.   In addition, the comments did not provide estimated completion dates.   As a result, the AAA did not document a commitment to completely correct the reported conditions. The following are examples of management comments that lacked specificity and estimated completion dates.

   a   "The *three* Deputy Auditor Generals agreed with the recommendation and said they would continue to demonstrate that follow-up work is valued and important."

   b.   "The *three* Deputy Auditors General agreed with the recommendation to ensure the appropriate factors are considered in deciding the proper engagement type."

Suggestion 3. The Deputy Auditor General for Policy and Operations Management should assure that actions management agrees to take in future quality assurance reports are specific and include a timeline for completion.

Management Comments. The Deputy Auditor General for Policy and Operations Management concurred with the observation and suggestion and stated: "We will ensure all recommendations in future quality assurance reports have suspense data, and that comments provided by the operating Deputy Auditors General are specific and adequately address recommendations made by the quality assurance team, to include the timetables for completion. Additional Information. In March 2002, we developed and implemented a quality assurance monitoring/tracking system for recommendations made during our quality assurance reviews. The system is online and accessible by all Agency personnel, and the system highlights key areas such as-report number, recommendation, accountable directorate, status, target and implementation dates."

Observation 4 — Quality Control.
Audit teams did not always comply with AAA established quality control requirements consisting of reviewing working papers, completing the internal quality control review checklist, and independently referencing the draft report. For one project reviewed, the audit team did not complete any of the quality control requirements. Completing the quality control requirements helps assure auditors follow government auditing standards and prepare well-supported audit reports.

a. Supervisory Review. Three supervisors did not initial and date the project working papers, and a fourth supervisor only initialed a portion of the working papers. Further, four supervisors did not document their working paper reviews on audit review sheets, as AAA regulations require. Instead, the supervisors reviewed the working papers and then discussed them orally with the auditors. For example, one supervisor stated that when he was dealing with "seasoned auditors" he would just verbally tell them if they overlooked something. While oral discussions are important, documenting working paper reviews and subsequent discussions is also important to assure that major points are understood and the auditors acknowledge and accomplish any additional taskings.

b. Internal Quality Control Review Checklist. Supervisors for three projects did not complete the internal quality control review checklist! Further, one supervisor that completed the checklist did not do so until 4 months after the final report was issued, and another supervisor only completed part (50 to 75 percent) of the checklist. Although our review did not disclose material problems with any of the nine audits reviewed, quality control steps are essential to ensure conformance with auditing standards. This is a repeat observation from the 1999 peer review.

Review Comment. The AAA issued a quality assurance report on 19 March 2002 that identified this same condition (i.e., that audit supervisors were not completing the required internal quality control review checklist). The AAA's report contained recommendations for

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[4] The internal quality control review checklist is one element of AAA's quality assurance program. The checklist parallels the audit process and contains separate sections on audit planning, execution, and reporting. Supervisors are required to complete the checklist to help assure audits are accomplished in accordance with auditing standards.

corrective action that were ongoing at the time of the peer review. Consequently, this report contains no suggestions addressing this issue.

c. **Independent Referencing**. dit teams 1 t always follow AAA policies and procedures wl they indep dently referenced draft « Specifically, audit teams **did not** independently reference draft reports prior to issuance(**3** projects), did not utilize an independent party to reference reports (2 projects), and did not **reference** subsequent changes (3 projects). In addition, referencers did not verify facts to supporting working papers (5 projects), and they did not verify all facts and figures (6 projects). Finally, **supervisors** did not **review** and sign the referencing notes (2 projects). This is **also** a repeat observation from the 1999 peer review Several factors contributed to this condition.

(1) <u>Familiarity</u>. Some auditors indicated a lack of familiarity with the specific referencing requirements. For example, one audit supervisor stated his understanding **was** that auditors could choose to reference either the draft or the **final**. He referred to the certification form that had options for "Draft" or "Final" referencing. He **stated** he was not familiar with the USAAAR 36-85, Independent Report Referencing, 31 October 1996, requirement to reference drafts before releasing them to management. Another auditor stated he did not realize he was supposed to put tick mark on the supporting working **papers**. Finally, an audit manager stated she had "no idea" independent referencers were supposed to initial **source** documents. One referencer indicated he had **never** initialed source documents before.

(2) **Supervisor Oversight**. Supervisors did not ensure referencers understood and complied with the established referencing procedures. For example, one supervisor said he was not aware that the referencer **was** not **initialing** supporting **working papers** because he only signed the Form 371 and did not review or verify that **referencing was** done correctly. Another supervisor said he did not reference changes **because** he saw no "value added" to referencing changes.

Suggestion 4. The Deputy Auditor General for Policy and Operations Management should:

a. In coordination with the operating Deputy Auditors General, remind audit supervisors of their responsibility to review, initial, and date working papers and prepare review comments to document their observations. This is particularly important when the **supervisor** notes additional actions that need to be accomplished or actions that the auditors overlooked.

b. Reauire **supervisors** to **(1)** review USAAAR **36-85** referencing **procedures** with the independent referencer prior to starting each referencing assignment and (2) periodically review referencers' work to assure conformance with USAAAR **36-85** referencing requirements.

Management Comments. The Deputy Auditor **General** for Policy and Operations Management concurred with the observation and suggestions and stated:

a. "We coordinated this issue with the operating Deputy Auditors General and they agreed to remind their respective teams of the importance and need for supervisory reviews. Specifically, for the three operating Deputy Auditors General, one:

- Scheduled the audit manager for the quality assurance team to brief supervisory review issues identified during recent quality assurance reviews and the peer review at the directorate's team meeting on 24 July 2002.

- Is going to develop and distribute correspondence to all audit supervisors and managers within the directorate addressing supervisory review issues by 30 August 2002.

- Is going to issue a message to all auditors within the directorate addressing supervisory review issues by 30 September 2002.

In addition, we briefed this issue at the Agency-conducted supervisory school in April 2002, and sent an email to all Agency supervisors and managers pertaining to their respective supervisory review responsibilities in May 2002. **Additional Information.** During one of our quality assurance reviews (A-2002-PMO-0552.000, dated 25 March 2002), not selected during the peer review, we concluded that responsible managers didn't always provide sufficient evidence supporting supervisory review. Operating Deputy Auditors General concurred with the recommendation requiring program directors to amend FY 03 performance standards holding audit supervisors and managers accountable for implementing quality controls (to include supervisory reviews) during engagements."

b. "We will update USAAAR 36-85 to include a requirement for supervisors to review and discuss independent report referencing procedures with the respective independent referencers prior to the effort. Our target date for completing the regulation is 31 December 2002. In addition, we will periodically review referencers' work to ensure compliance with USAAAR 36-85. **Additional Information.** During one of our quality assurance reviews (A-2002-PMO-0552.000, dated 25 March 2002), not selected during the peer review, we identified deficiencies with independent referencing and included a project in our draft FY 02-03 quality assurance plan to review this area. We are planning to review this area during the last quarter of FY 03."

Observation 5 − Financial Audits. The AAA did not prepare, and/or update from prior years' audits, certain documents the US General Accounting Office GAO/PCIE Federal Financial Audit Manual, January 1993, requires for financial statement audits. Specifically, the audit of the Army's General Fund Principal Financial Statements for FY 2000, and the related

"feeder" audits,[5] lacked updated cycle memoranda,[6] account risk analyses,[7] specific control evaluations,[8] and sampling plans.[9] The AAA made a conscious decision not to prepare or update these documents because Army information systems were not yet capable of producing auditable financial statements allowing the AAA to form an opinion. The AAA audit teams believed they could spend the considerable time it would take to prepare/update these documents more profitably on other audit priorities. However, the auditors did not document in their working papers the decision not to prepare and/or update the documents, provide corresponding rationale, and explain the impact on the: audits.

Suggestion 5. The Deputy Auditor General for Policy and Operations Management should require auditors to document in the working papers reasons for not preparing or updating cycle memoranda and other documents required for financial statement audits. The rationale should also describe the impact that non-achievement will have on the audit results, if any.

Management Comments. The Deputy Auditor General for Policy and Operations Management concurred with the observation and suggestion and stated: "We will update our audit working paper regulation (USAAAR 36-72, Audit Working Papers, 31 January 1992) to include a requirement for auditors to document reasons for not preparing or updating cycle memoranda and other documents required for financial statement audits, and describe the impact that non-achievement will have on the audit results in the working papers. Our target date for completing the regulation is 31 January 2003."

Additional Comment - Continuing Professional Education. Auditors reviewed in the 2002 peer review generally met continuing professional education (CPE) requirements. Of 89 auditors reviewed, 87 auditors (98 percent) could provide documentation indicating they met N 2001 education and training requirements. Eighty auditors (90 percent) had supporting documentation for their FY 1999/2000 education and training. This represented substantial improvement over the 1999 peer review where in only 56 percent of the auditors reviewed had documentation supporting their CPE accomplishments.

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[5] The AAA accomplished several audits, referred to as "feeder" audits, to support the FY 2000 General Fund financial statement audit. A partial list of the feeder audits includes: civilian accrued leave, military pay, construction in progress, munitions, real property, general equipment, and liabilities.

[6] Auditors prepare cycle memoranda to document their understanding of the entity's information systems for processing and reporting accounting, compliance, and operations data.

[7] Auditors prepare the Account Risk Analysis to identify significant line items, accounts, and assertions. For each significant line item, the auditor should use the Account Risk Analysis form to document the significant transaction cycles and the specific significant accounting applications that affect these significant line items and accounts.

[8] Auditors prepare the Specific Control Evaluation to group potential misstatements and control objectives by accounting application, providing a format to perform and document the evaluation and testing of internal controls efficiently.

[9] Auditors generally obtain audit evidence using sampling procedures to select individual line items. Auditors should document the sampling plan in the working papers.

EVALUATION OF MANAGEMENT COMMENTS

AAA actions planned arc responsive to the issues and suggestions contained in the report.

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   Systems Division
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cc:
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